An Analysis Of Three Confronting Theories To Explain Franchising Supply

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ABSTRACT

In this article, we have analyzed one of the most relevant lines of research in the franchising literature - the creation of a franchising system. Three confronting theories are reviewed and presented in this paper to explain the franchising phenomenon; namely, the resource scarcity theory, the agency theory, and the plural from theory. The conclusion of our analysis is that probably none of them is able to explain the full franchising occurrence, but each theory explains different parts of the franchising phenomenon, so they should be perceived as complementary theories.

Keywords: Franchising; Resources; Agency Theory; Uniformity; Adaptation

THE DECISION TO FRANCHISE: A THEORY OF FRANCHISE SUPPLY

An impressive amount of theoretical and empirical research has been conducted to explain why firms choose to distribute their product or service offerings through franchise channels. The franchisor's decisions to franchise vs. own the business discusses the franchisor choice of franchise (market) vs. company ownership (hierarchy) — in essence, a theory of franchise supply. Hunt (1977) assured that, for potential franchisors, "franchising held out the promise of the American Dream, the dream of making it big", and this idea of "making it big" is one of the main reasons that owners of franchising companies argue for using the franchise system. No doubt, franchising helps rapid growth, but it also involves a loss of control over the business. In many industries, we see chains that extensively use franchises competing with chains that never franchise, and it seems that both alternatives can work and succeed, so why use franchising? And what are the rationales for using franchising instead of growing through company-owned units?

The classic literature on this subject, all of which is strongly rooted in economics, can be grouped into two different theories to explain why a company decides to franchise - the Resource Scarcity Theory (Oxenfeld and Kelly, 1969; and Norton, 1988) and the Agency Theory (Brickley, Dark, and Weisbach, 1991; and Lafontaine & Kaufmann, 1994). More recently, another competing theory has emerged which seeks to explain the prevalence of the franchise system on the basis of the organizational characteristics that differentiate it from other forms of ownership - the Plural Organization Theory (Bradach & Eccles, 1989; and Bradach, 1997). In what follows, we will look at the treatment received by each of these competing theories in the literature on franchising, trying to find a common ground and reconciliation between them.

RESOURCE SCARCITY THEORY: FRANCHISING TO GAIN RAPID ACCESS TO FINANCIAL RESOURCES

Franchising is a cheap and fast way to grow because the franchisee supplies the franchisor with one of the basic resources to develop a business - money. The franchisor faces a need for growth to achieve economies of scale and market share, particularly in the early stages of the operation when they usually face a scarcity of financial resources to fund the growth. The franchisee not only contributes to the franchisor with fees and royalties, but also finances the investment to start the operation and provides the ongoing capital required to continue the operation.

So, franchising appears to be the best solution when there is a need to grow fast and when the franchisor needs to gain access to financial and human resources at a low cost. Caves and Murphy (1976) stated that the franchisee is the most inexpensive source of resources that a franchisor might find to fund growth and that there is no economically efficient substitute for the financial resources supplied by the franchisee. This is the theory developed by Oxenfeld and Kelly (1969) known as the Resource Scarcity Theory, which explains that the reason for the franchisor to use the franchising system originates in having access to a resource possessed by the franchisee and basic for the growth of any business - the financial resource.

Revising the Resource Scarcity Theory into a financial theory framework, Rubin (1978) found that the franchisor would find more optimal financial sources than the franchisee. Even when franchising would not be the most optimal source of capital for the franchisee, Lafontaine and Kaufmann (1994) emphasize that, added to the argument that the franchisee brings together money and management, franchising has another advantage over selling company shares - keeping control. Indeed, selling company shares to external investors implies losing strategic control; usually the investors will be partners of the company with the right to influence the company's strategic decisions. Alternatively, using franchising implies that the "partners" are individual franchisees who are financing the growth, but do not hold shares in the company; so the franchisor keeps full strategic control of his company.

Implicit in the Resource Scarcity Theory is the fact that the franchisor is using the franchising system because he has no access to financial resources. In other words, if the franchisor had easy access to these resources, he would not use franchising, but would prefer growing with a company-owned configuration. As a consequence, franchising would be a temporary organizational resource used to deal with the difficulty to access the basic resources necessary for growth; and once the franchisor had access to those resources, he would change to company-owned growth. This is the thesis developed by Oxenfeld and Kelly (1969), known as "ownership redirection", which predicts that the franchisor will stop franchising once he has the necessary resources to fund growth, and eventually the franchisor will re-buy the once-franchised stores from the franchisees.

The ownership redirection hypothesis predicts that in the long run, most of the franchising chains will evolve to 100% company-owned chains, leaving only a few marginal outlets in franchisee's hands (due to geographic remoteness or poor performance). Subsequent studies, however, show that there is no empirical evidence of such ownership redirection. Indeed, the evidence in many analyzed industries is that franchising chains remain this way even when they have full access to capital. The empirical evidence suggests that franchising chains tend to adopt dual structures, having at the same time company-owned and franchised structures. More intriguing is the fact that many franchising companies give financial support to their franchisees; that is, the franchisees are not contributing money, but only their own managerial talent. Why are franchisors financing franchisees? Clearly, Resource Scarcity Theory cannot explain this paradox.

AGENCY THEORY: FRANCHISING TO HAVE BETTER AND MORE MOTIVATED MANAGERS

It seems that Resource Scarcity Theory explains part of the reason to franchise, but not all of it. The main reason to doubt Resource Scarcity Theory is that the empirical evidence shows many franchising chains continue franchising even though they have plenty of resources. Thus, when these companies are using franchising, it is not because they face financial resource scarcity, but because franchising gives additional advantages to the franchisor, which are not explained under the Resource Scarcity Theory.

Contrary to Resource Scarcity Theory, some researchers have highlighted the idea that the franchising system has indeed a more important aspect than financial resources - the motivation of the franchisee. The idea is that the franchisees are risking their own money in the franchised business; they are the owners of the business, so they have all the incentives to work hard and make it a profitable operation. The motivation of the franchisees is superior to the motivation of the company managers, even when the company managers may have a variable salary dependent upon their performance - the motivation of risking their own money is higher than any variable compensation we might think about.

Brickley et. al. (1991) developed the idea that the franchising system is an effective response to the classic principal-agent problem studied in Agency Theory. Agency Theory explains that when there is a separation between the property (the principal) and the manager (the agent), there is an agency problem; that is, the principal is always uncertain about the behaviour of the agent. The question that faces the principal is whether the agent is putting all his effort into achieving the goals defined by the principal, and if the agent is behaving in the interest of the principal, or in the agent's own interest. Under uncertainty and imperfect information conditions concerning the agent's effort, the principal incurs monitoring costs to check on the agent's effort; i.e., agency costs. The only way to reduce these costs is to give the agent residual rights that align his personal interests with the interests of the principal, and that is exactly what the franchise contract does - aligns the interest of franchisor and franchisee.

Agency Theory explains that the franchising system reduces the principal-agent problem because the franchising contract aligns the interests of both the franchisor and the franchisee and sets a common goal that both share. There is no principal-agent duality in the franchising contracts because there is no separation of property and management; that is to say, the franchisees are not employees (agents) of the franchisor, but the owners of their own business, and so it is in the franchisee's best interest to put all his/her efforts into making a higher profit from the business. Thus, franchising is a powerful motivator for the franchisee and reduces the monitoring problem that the franchisor would face if the franchisee was substituted by a company-hired manager.

Following the logic behind the Agency Theory explanation of why firms decide to franchise, the conclusion should be that, because franchising is such a powerful motivator, to take full advantage of it, franchising chains will ultimately become 100% franchised. Namely, they will convert all the company-owned properties to franchised properties to take advantage of the reduced agency cost associated with the franchise system. That is exactly the opposite prophecy that Resource Scarcity Theory makes - that franchised chains will ultimately become 100% company owned. Agency Theory advocates like Martin (1988) predict that franchised chains that combine a mix of company-owned and franchised structures will evolve to be fully franchised companies.

The reality check for this prediction gives the same result as the one for the ownership redirection forecast - there is no empirical evidence that the franchising chains are evolving to be 100% franchised, just as there was no empirical evidence to support the affirmation that they were evolving to be 100% company owned. What we observe is that most franchising chains keep a stable mix of company-owned and franchised outlets.

PLURAL ORGANIZATION THEORY: FRANCHISING TO ACHIEVE UNIFORMITY AND ADAPTATION

The empirical evidence reported supports the idea that neither the Resource Scarcity Theory nor the Agency Theory is able to explain the whole franchising decision. Despite the controversy between the two theories, it seems that both are more complementary than contradictory. Resource Scarcity explains one part of the problem and Agency Theory explains another part of the problem, but the predictions of both theories - Resource Scarcity, predicting an evolution to fully company-owned chains and Agency Theory, forecasting an evolution to fully franchised chains - have not been fulfilled. What we find in reality is that most of the franchising chains maintain a mix of company-owned and franchising structures. Facing the fact that the prevalence in the industry is mixed structures, Bradach (1997) formulated his Plural Organization Theory, which explains that the mix of company-owned and franchised properties under the same brand; namely, the Plural Form, is what gives the organization a competitive advantage over systems that are fully franchised or fully company owned. Bradach (1997) found that most of the franchising chains have a mix of company-owned and franchised establishments. One of the reasons he gave for this is that some establishments are more suited to one form of ownership than others. The other reason is that the existence of one kind of outlets has positive impacts on the other kind of outlets, and vice versa. Under this theory, the reason to franchise is to have simultaneous access to the most important advantage of the company-owned structure – uniformity - and the most important advantage of the franchised structure - adaptation.

Uniformity and adaptation are two key goals - often contradictory - that any kind of business must achieve to survive. Uniformity means that the customer must find a common image, design, and service experience in any outlet under the same brand; namely, the brand image, which has to be consistent all over the brand's properties whether they are franchised or company owned. Adaptation means almost the opposite - the chain must adapt to changing markets to take advantage of new threats and opportunities and to adapt to the local markets where it is competing. To do that, the chain needs constant innovation and a deep knowledge of the local markets.

Even when uniformity and adaptation seem to be two contradictory objectives, using a mix of franchised and company-owned units - a Plural Form - allows the company to achieve the two goals simultaneously.

The company-owned units are managed following rigorous bureaucratic systems and strict quality controls are carried out to assure that the product and service quality meet the standards defined by the chain. On the other hand, the franchised units provide an entrepreneurial and innovative spirit for the chain, while maintaining the uniformity standards developed in the company-owned properties. As Bradach (1997) stated, "the emphasis on control in the company-owned units does not create a context hospitable to innovation and adaptation."

The thesis of the Plural Form Theory is that chain organizations are more than the sum of their parts - by having both company and franchise arrangements together, a chain can leverage some of the strengths and overcome some of the weaknesses associated with each arrangement (Bradach, 1997).

CONCLUSION

To conclude this analysis of the three competing theories and their power to explain why franchising occurs, we could say that the three theories explain different parts of the franchising phenomenon. And, in fact, when asking franchisors why they decided to franchise their brand and why are they still franchising, it seems that the answers move sequentially from Resource Scarcity explanations to Agency Theory motives to Plural Form advantages. Indeed, it appears that for many franchising chains, there is a learning process through which the chain moves from an initial pure economic reason to franchise - to gain access to capital to finance the growth of the chain, to a second step of management-related reasons - to have better and more motivated managers, to a third step of strategic reasons - to achieve uniformity and adaptation in the chain.

In other words, the franchisor starts valuing the most evident aspects of franchising (easy and quick access to capital and management) and then moves to a more subtle strategic rationale to franchise (achieve uniformity and adaptation in the chain), reflecting what Mintzberg (1973) would call an emergent strategy - a strategy whose benefits are perceived ex-post through a learning process once the strategy has been implemented.

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